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Via Messenger

Mr. David S. Guzy, Chief
Rules and Procedures Staff
Minerals Management Service
Royalty Management Program
P.O. Box 25165, MS 3101
Denver, Colorado 80225-0165

Re: Comments - Proposed Rulemaking - Amendments to Gas Valuation Regulations for Federal Leases, 60 Fed. Reg. 56007 et. seq.

Dear Mr. Guzy:

We have been retained by Tom Brown, Inc. ("TBI") to submit comments to the above-referenced rulemaking.

TBI appreciates the opportunity to provide these comments during this formal rulemaking process. TBI believes that some of the proposals will be an improvement in computing and paying Federal royalties. However, other proposals will introduce unnecessary complexities to royalty valuation and accounting and we urge MMS not to adopt them.

The proposals to eliminate allowance forms, eliminate dual accounting for non-arm's-length sales of processed gas, redefining the term "gathering", permitting deduction of downstream compression expense and permitting valuation of natural gas liquids on a wellhead MMBtu basis are helpful steps in the right direction and will assist in improving royalty accounting and payment procedures.

However, a special comment is in order with respect to permitting the deduction of downstream compression expenses. Over the years MMS and State auditors have confused the non-deductibility of expenses for such matters as compression, dehydrating and gathering with beneficial use of gas. We believe it would be advisable for the final regulations to clear up this confusion by restating the following comment by MMS which appeared in the final rule for revision of gas royalty valuation regulations which appeared at 53 Fed. Reg. 1230, 1233 on January 15, 1988:

> The determination of whether or not gas has been unavoidably or avoidably lost and whether or not gas used as royalty-free (whether used off lease or on lease) are operational matters covered by the appropriate regulations of the Bureau of Land Management (BLM) and MMS for onshore and offshore operations respectively. The BLM's requirements are governed by the provisions of 43 C.F.R. Part 3160 and Notice to Lessees and Operators Number 4A. The MMS's requirements are governed by the provisions of 30 C.F.R. Part 250. ...

The proposed regulations appear to perpetuate this confusion. In proposed 30 C.F.R. 202.450(b), MMS restates the 1988 rule but then adds the following sentence to the proposed rule:

> However, except as provided in Section 202.451(b), in no instances will any gas be approved for use royalty-free downstream of the facility measurement point approved for the gas.

The sentence quoted above appears to conflict with the prior sentence of the proposed rule and with the language quoted above from the final rulemaking for the 1988 regulations. Under Notice to Lessees No. 4-A (NTL-4A), the BLM has jurisdiction to determine if gas is being put to a beneficial use on or <u>off</u> the lease for onshore operations, not the MMS. Frequently the BLM has approved royalty-free gas beyond the facility measurement point. It appears to us that the sentence quoted above from the proposed rule will interfere with the jurisdiction of the BLM to make this determination. We recommend that the last sentence of Section 202.450(b)(1) of the proposed rule be changed to read as follows: "However, except as provided above in this section as well as Section 202.451(b) and under Notice to Lessees No. 4-A, will any gas" etc. As stated earlier, MMS should make it clear that it does not have jurisdiction for onshore beneficial use determinations.

MMS requested comment on several issues which TBI wishes to address. With respect to the request for comments on improving benchmarks to be applicable when there is a non-arm's-length contract, TBI believes that value for royalty purposes in this situation should be compared to comparable arm's-length contracts in the same field or area as presently provided in the existing benchmarks. TBI is opposed to any attempt to use an affiliate's gross proceeds as the basis for royalty valuation. TBI believes that this approach will lead to protracted litigation and will be counter-productive to the maintenance of an efficient royalty management system.

The proposal to conduct rulemaking on "improved benchmarks" is a thinly veiled attempt to capture downstream values on a product that has been enhanced solely by the efforts of the lessee and not the Federal government. With the regulatory prohibition against deduction of compression, gathering, dehydration and other gas conditioning costs by a Federal lessee, the Federal lessor is sharing in the enhanced value of a product which is contrary to fundamental principles of a royalty. Essentially a royalty is a share of production in kind (or value) at the wellhead, See: Law of Federal Oil and Gas Leases Section 13.01[1] p. 13-3 (Rocky Mountain Mineral Law Foundation 1994), and is based upon wellhead values in the same field or area and not higher values which are created downstream of the lease and away from the wellhead. It is particularly inappropriate to seek royalty on a product which has been transformed downstream from the royalty product which existed at the time of its production at the wellhead. In many instances, particularly in the Rocky Mountain states where TBI operates several Federal wells, gas sometimes has no value at the wellhead because of the unmarketable condition of the gas at that point due to impurities and other substances in the gas stream which are not acceptable for pipeline delivery. When the lessee assumes the entire cost of conditioning the gas into a marketable product, it is unfair for the Federal lessor to seek a royalty on a product which has not been enhanced by the Federal lessee. Therefore, MMS should not promulgate regulations which tries to extend a right to a royalty beyond the point where it is appropriate.

The MMS also requested comments on seeking royalties on settlements resulting from contract disputes between gas producers and gas purchasers. No consensus was reached by the Negotiated Rulemaking Committee. Therefore, there is no justification to propose a regulation which is not based on consensus of the committee when the charter of the committee is considered. We strongly urge MMS to remove the proposal from the rule. Substantively, TBI opposes the collection of royalties on gas contract settlements. We believe MMS should suspend any rulemaking on this issue until pending litigation has been resolved in a final non-appealable order in the courts.

The MMS also requested comment on what should occur if MMS is unable to make the final two-year safety net median price determination. We believe that two years is more than adequate time for MMS to make this determination and if it fails to do so, then it should not publish a final safety net median price at all. Lengthening the time in which this determination will be made is particularly burdensome and onerous on independent producers. To drag this determination out forcing the lessee to continue to provide for this contingency in future years is onerous and burdensome. Also, it appears to extend the audit period unnecessarily. If MMS is unable to make the final safety net determination, then the books should be closed and prices received by a lessee for the production year involved should be accepted subject to audit.

One further comment is appropriate at this juncture regarding the safety net rule. As TBI understands it, the safety net will be based on a comparison of prices received based on the index for a given production with the gross proceeds received in arm's-length contracts in the same field or area. Since the index is based upon spot prices, TBI believes it is patently unfair to use other types of contracts with which to compare spot contracts. Several producers do make arm's-length long-term arrangements for the sale of gas outside the spot market. Many producers are selling gas in present sales for terms of one year or longer and basing the price on indices other than spot pricing such as NYMEX. The purpose is to ensure a price stability so that the producer can go forward with planning its exploration and development projects without being subject to the vagaries of the market. TBI submits that spot contracts should not be compared with any other type of contract except other spot prices in the same field or area. The better rule is that if gas is sold in the spot market under an arm's-length contract which complies with other MMS valuation regulations, then there should be no comparison of other prices in the field or area. Of course MMS has the statutory duty to audit royalties, but it should not reject a price paid under an arm's-length contract unless there is evidence of misconduct or a breach of the marketing covenant as presently required by current regulation. It appears to us that the development of the index and the safety net regulations is a thinly veiled attempt to require all arm's-length gas sales agreements to be valued as if they were non-arm's-length contracts if the producer elects to value the gas according to index.

In the preamble to the 1988 regulations, MMS made the following statement:

> ... MMS maintains that gross proceeds to which a lessee is legally entitled under arm's-length contracts are determined by market forces and thus represent the best measure of market value ...

53 Fed. Reg. 1186 (January 15, 1988).

It is clear to us that initial values based on index, even if sold under arm's-length contracts, are no longer acceptable and are subject to adjustment for up to two years later under the proposed safety net regulation. TBI submits that MMS should continue to follow the principles quoted above from the 1988 regulations and not force lessee to comply with the complicated and arcane index and safety net regulations.

TBI urges MMS to establish a system to monitor closely the effectiveness of the safety net rule and abandon it if it appears that it is unnecessary and no longer effective. As long as prices are based on free interaction between purchasers and the sellers of gas in arm's-length transactions, then the safety net rule should be abandoned and royalties should be based upon gross proceeds received under arm's-length transactions subject to audit in appropriate circumstances.

The MMS also requested comment on accounting for royalties from leases, units and communitization agreements consisting of 100% Federal interests. TBI believes in such situations producers should be allowed to pay on takes rather than entitlements. Since all producers have a common obligation under substantially identical leases, there is no reason to complicate royalty valuation with an entitlements approach.

We disagree with the finding of the Department with respect to the Regulatory Flexibility Act (60 Fed. Reg. 56015). We dispute the certification of the Department that this rule will not have significant economic effect on a substantial number of small entities under the Act. The statement that: "these changes would add several alternative valuation methods to the existing regulations" is hardly a basis to conclude that the rule will not have significant economic effect. We submit that the rule fails, contrary to the pronouncements in the preamble to the rulemaking, to simplify, clarify, and improve royalty accounting for Federal gas. With the addition of index pricing, the safety net regulation, the transportation allowance calculations and many other aspects of this rule, the independent producer will have to incur additional cost and expense by the employment of additional personnel or contracting such work out at cost. None of these expenses would have been necessary under the existing rule and therefore it will increase operating costs for these leases. TBI submits that the impact will be felt most significantly on low producing wells, many of which exist throughout the Rocky Mountain states and may cause premature abandonment of producing properties. In this situation everyone loses, the United States, the States and Indians when royalty revenues cease because of excessive regulation. We believe a cost/benefit analysis would show that the costs of complying with this regulation outweigh the benefits.

The economic impact of this regulation will be most severe in the Rocky Mountain states where TBI operates several Federal wells. Gas prices in this area are among the lowest in the nation. As government regulation increases, it only shortens the day when many wells will have to be plugged and abandoned, and with it the termination of royalty and tax revenue to Federal, State and local governments.

We believe that a more in-depth analysis of the economic effect of this regulation needs to be done. We seriously doubt that any meaningful economic analysis will support the Department's certification under the Regulatory Flexibility Act.

TBI believes it is unfair to require a payor to true-up to the safety net, but not allow a credit for payments above the median price. If a safety net is to be used it should cut both ways. As proposed, the safety net regulation is arbitrary, capricious and an unwarranted taking of constitutionally protected property rights. TBI disagrees with the certification of the Department that a Takings Implication Assessment need not be prepared under Executive Order 12630, "Government Action and Interference with Constitutionally Protected Property Rights". As discussed above, if the Department is committed to values for royalties based upon interacting market forces, then it is improper and unlawful to collect royalty which is based upon values which do not reflect actual value especially where it can be established that no gas is actually being sold in a given zone at the median price. A Takings Implication Assessment should be prepared where a regulation seeks to extract a value which is in excess of market value especially where the Department has made the commitment to market forces being the best measure of value (see p. 10 hereof).

Also, the determination of zones which will be appropriate for index pricing should not be published by MMS without prior notice and invitation for public comment. There are many areas in the Rocky Mountain states which may be viable zones for index pricing which have not been identified which produce substantial quantities of gas. Industry and the States should have an opportunity to comment on the formation of zones and also on the viability of zones.

Also, the rulemaking is deficient in its failure to address valuation of high cost natural gas including coalbed methane and high sulphur gas. New technology has enabled the industry to tap these resources. However, the cost and expense to do this is substantially greater than production of conventional gas because of the need to extract water and CO_2. The proposed regulations are inadequate to address this unique circumstance. Valuation of royalties on these products should be based on a system which is fair and not counter-productive. MMS needs to revisit this issue by either reconvening the Negotiated Rulemaking Committee or referring it to the Royalty Policy Committee.

With respect to proposed regulation 202.450(d)(iv)(C)(3), where the operating rights owner takes none of its entitled share of production and the production cannot be valued using an index-based method as if it had been taken, five benchmarks are proposed. We suggest changing benchmark number (3) - "the weighted average of the operating rights owner's gross proceeds under arm's-length contracts for that month in the field or area" - to number (1) and renumbering the remaining benchmarks accordingly. Using the current month's value in the field or area is much less complicated than having to average the last three months. Using the current month's value will lessen the administrative burden for both MMS and industry. If there are no sales for the <u>immediate</u> previous three months, what is the alternative? This issue was not addressed. Without it, confusion is likely to occur.

As to proposed regulation 202.452(b)(3) - Standards for reporting and paying royalties on gas. This section requires reporting NGLs in standard U.S. gallons, <u>except for</u> zones with an active spot market and valid published indices. This seems to be an unnecessary complication of the rule. NGLs are sold on an MMBtu basis and could be much more simply reported on the same basis. To do so better meets MMS' and industry's objective of reporting consistency. Moreover, reporting all gas and gas products on an MMBtu basis will eliminate confusion on the part of payers as well as the increased likelihood of reporting errors.

As to proposed regulation 206.454(e)(7), there are questions which should be addressed regarding the convening of a technical procedural review (TPR) where the final safety net median value is disputed. How will notification to "all affected parties" be made? What happens if a company does not or cannot participate in the review and the value is later modified? Will all companies within a zone be notified of any modification to the safety net median value? These issues need to be addressed. Most importantly, TBI strongly objects to the TPR decision as nonappealable. Since it would have the same binding final effect as other administrative orders and would have a significant impact on the valuation of royalties, fairness and administrative due process requires it be subject to further review, if a lessee so elects.

With respect to proposed regulation 206.456 - Transportation allowances - general. As discussed in the preamble, the Reg-Neg Committee employed the term "location differential" but in the proposed rule, the term "transportation allowance" is used for the same purpose without giving any reason for the change. The term "location differential" was used to distinguish between a company's actual costs for transportation and amounts that reflect a reasonable cost for transporting gas to the Index Pricing Point ("IPP"). TBI recommends, consistent with the Committee consensus, the term "location differential" be reinstated in the final rule and defined as approved by the Committee.

With respect to proposed regulation 206.457(c)(2)(iv)(A) and 206.459(b)(2)(iv)(A) - Determination of transportation allowances, and Determination of processing allowances.

These sections provide that for transportation systems and processing plants, respectively, purchased by the lessee or the lessee's affiliate that do not have a previously claimed MMS depreciation schedule, the lessee may treat the transportation system or processing plant as a newly installed facility for depreciation purposes. We strongly believe that if new capital is invested which would extend the economic life of producing Federal leases, then a new depreciation schedule should be approved for the new capital.

With respect to proposed regulations 206.457 and 206.459 - General. The proposed rule does not distinguish between arm's-length and non-arm's-length transactions in reporting processing allowances and it is unclear whether allowance forms are eliminated for non-arm's-length transactions. TBI supports the Committee recommendation (Committee Report, page 73) that all transportation and processing allowance forms be eliminated for both gross proceeds and index-based payers. Therefore, we recommend that, in keeping with its commitment to eliminate allowance forms, MMS must eliminate all transportation and allowance forms for both arm's-length and non-arm's-length sales in the final rule.

With respect to proposed regulation 211.18(c)(3) - Who is required to report and pay royalties? TBI supports this regulation so that lessees have an exception to report and pay royalties on their entitled share of production where all operating rights owners in an agreement can agree on common reporting and payment responsibilities among themselves.

Also in the preamble to the proposed rule, at page 56015, MMS requests comments on how best to accommodate supplementary reporting. TBI recommends all issues arising from these regulations that may require modification to reporting requirements, including supplementary reporting as well as reporting of NGLs be referred to the Royalty Policy Committee's Subcommittee on Royalty Reporting and Production Accounting. Clearly, this Subcommittee is the most appropriate venue for determining the most efficient, streamlined, accurate reporting methodology under the amended regulations.

Sincerely,

Hugh V. Schaefer

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